

**The Tax Exempt and Government Entities
Division Could Improve the Efficiency of Its
Advance Ruling Follow-Up Process**

August 2003

Reference Number: 2003-10-141

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 200005

August 22, 2003

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

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FROM: Gordon C. Milbourn III
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Corporate Programs)

SUBJECT: Final Audit Report - The Tax Exempt and Government Entities
Division Could Improve the Efficiency of Its Advance Ruling
Follow-Up Process (Audit # 200210051)

This report presents the results of our review of the advance ruling follow-up process. The overall objective of this review was to evaluate the Exempt Organizations (EO) function's process of following up on advance rulings and appropriately classifying the exempt organizations.

In summary, the EO function implemented several changes in the processing of Foundation Follow-Up¹ cases in 2002. The changes resulted in different personnel assuming responsibility for processing these cases. We determined that the current method for conducting Foundation Follow-Up reviews is a labor-intensive, manual process resulting in few changes to the foundation status of the tax exempt organizations. In addition, the financial information requested from tax exempt organizations during the Foundation Follow-Up process is already provided by those organizations that annually file a Return of Organization Exempt From Income Tax (Form 990). We determined that 78 percent of the exempt organizations in which a Foundation Follow-Up was necessary in Fiscal Year 2001 were required to file a Form 990. By making better use of available information on the Form 990, EO function management could more efficiently perform Foundation Follow-Up work. This would reduce the burden on some of the exempt organizations and may allow more effective use of available EO function resources. We estimate that up to 10.73 Full-Time

¹ Foundation Follow-Up refers to the process of EO function personnel requesting exempt organizations to substantiate the amount of public support they have received for the 5 years of their advance ruling period.

Equivalents (FTE)² could be reallocated to more productive oversight of exempt organizations, such as determination or examination work, if available financial information was used.

We also determined that an Internal Revenue Service (IRS) computer system does not always contain accurate information related to exempt organizations that have been reclassified as private foundations during the Foundation Follow-Up process.

We recommended that the Director, EO, pursue alternative approaches to more efficiently conduct Foundation Follow-Up reviews. In addition, we recommended that the Director, EO, reemphasize the use of an available management information report and create a new closing code on the Employee Plans/Exempt Organization Determination System to ensure this system contains accurate foundation status and filing requirement information.

Management's Response: The Commissioner, Tax Exempt and Government Entities Division, agreed to initiate changes in response to the recommendations made in this report. The Director, EO Rulings and Agreements, has given the Form 990 redesign group and the Form 990 e-filing initiative office 6 months to develop recommendations for using Form 990 information to determine foundation status. The Director, EO Rulings and Agreements, will request recommendations from the Manager, EO Determinations, regarding ways to ensure the accuracy of the Electronic Determination System (EDS). The EO function expects to implement the redesign of the EDS by December 31, 2005. The Tax Exempt Determination System team will be asked to address the issue of creating a closing code for presumptive rulings during the redesign phase. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

² An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

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The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

Background

An organization desiring to obtain recognition of its tax exempt status can apply under Internal Revenue Code (I.R.C.) Section (§) 501(c)(3)¹ to the Internal Revenue Service (IRS) for a determination of its exempt status. If the organization's application and supporting documents establish that it meets the particular requirements of I.R.C. § 501(c)(3), the Exempt Organizations (EO) function of the Tax Exempt and Government Entities (TE/GE) Division will issue a determination letter to the organization. The determination letter will affirm that the organization is exempt under I.R.C. § 501(c)(3). A determination as to whether the organization is publicly supported may also be made by issuing either a "definitive ruling" or an "advance ruling."

Definitive rulings are given if organizations meet the requirements of the law and have completed at least 8 months of their first year of operation. Advance rulings, based on Treasury Regulations, are given when organizations have not completed a tax year of at least 8 months. In an advance ruling, charitable organizations are granted a determination that they will be considered a publicly supported organization during a specified "advance ruling" period. The advance ruling period is usually 5 years from the date of formation of the exempt organization and is tracked on the Employee Plans/Exempt Organizations Determination System (EDS). At the end of the advance ruling period, EO function personnel request that the organizations substantiate the amount of public support they have received for the 5-year period. "Foundation Follow-Up" is the term applied to this practice. The EO function closed 14,223 Foundation Follow-Up cases in Fiscal Year (FY) 2002 and 16,458 cases in FY 2001.

I.R.C. § 501(c)(3) defines tax exempt charitable organizations. Once an organization has been granted exemption under I.R.C. § 501(c)(3), it can be classified as either a public charity or a private foundation. A publicly supported organization derives its financial support from governmental units and/or donations, grants, ticket sales,

¹ I.R.C. § 501(c)(3) (2002).

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and similar efforts. By contrast, a private foundation is supported by a limited number of sources and may be liable for some taxes. It is more desirable for an organization to be classified as a public charity than as a private foundation. Contributions to public charities are tax deductible to the extent of 50 percent of the donor's adjusted gross income (AGI).² Private foundation contributions are generally limited to 30 percent of the donor's AGI. Also, certain excise taxes are imposed on private foundations.

If an organization cannot substantiate public support after the 5-year advance ruling period, it is considered a private foundation as of the effective date of exemption under I.R.C. § 501(c)(3). The organization may be required to file a limited Return of Private Foundation (Form 990-PF) for each year covered by the advance ruling period. The adverse determination letter informing the organization of its change to a private foundation will also include instructions about the Form 990-PF filing requirements.

A former Ohio District Office of Research and Analysis study issued in 1999 reviewed the Foundation Follow-Up process. This study recommended that the EO function propose a change in the Treasury Regulations to eliminate the requirement of issuing advance rulings to reduce both the burden on charitable organizations and the cost to the IRS.

This audit was performed in accordance with *Government Auditing Standards* from September 2002 through April 2003. The audit was performed by interviewing EO function employees at the TE/GE Division Headquarters in Washington, D.C., and the Cincinnati Area Office, and by reviewing samples of closed Foundation Follow-Up cases. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

² AGI is income less certain deductions and expenses.

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The Foundation Follow-Up Process Can Be More Efficiently Performed

The current method for conducting Foundation Follow-Up reviews is a labor-intensive, manual process resulting in few changes to the foundation status of the exempt organizations. By making better use of available information on the Return of Organization Exempt From Income Tax (Form 990), EO function management could more efficiently perform Foundation Follow-Up work. This would reduce the burden on some of the exempt organizations and may allow more effective use of available EO function resources.

The processing of Foundation Follow-Up cases is very labor-intensive

To perform Foundation Follow-Up work, EO function personnel must conduct the following steps:

- Review EDS reports on a monthly basis and manually generate letters requesting the necessary financial information for all exempt organizations whose advance rulings end in that month.
- Send an additional letter (called a presumptive ruling) informing the organization that it is presumed to be a private foundation if the organization does not respond or does not provide sufficient financial information.
- Review the financial information (if provided) to determine whether the organization is a public charity or private foundation. If more information is needed, additional contacts with the organization will be made. The type of financial information requested by the EO function from tax exempt organizations is shown in Appendix VI.
- Issue a closing letter indicating the EO function's determination of foundation status to those organizations that provided sufficient financial information.
- Update IRS computer systems to reflect any changes to foundation status and associated filing requirements.
- Copy to microfiche all case file information and retain as required.

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Our review of sampled cases showed that the EO function performed the required follow-up reviews and properly classified the organizations as public charities or private foundations.³ Specifically, we determined that EO function personnel took action on all exempt organizations requiring follow-up during our audit period. In addition, we determined that EO function personnel properly determined whether these organizations were public charities or private foundations based upon their review of the financial information provided.

We did identify that the EO function did not always timely request the financial information from organizations, according to established procedures, and did not always make a timely final determination of foundation status after receipt of the financial information. However, in general, the EO function's untimeliness in sending the letters to request financial information did not affect the organizations' ability to provide the information to the EO function within the statutorily required time period. In addition, once the financial information was received, approximately 50 percent of the untimely determinations of foundation status were less than 30 days late. The delays in these two processes were primarily due to the large number of advance rulings requiring follow-up at the end of the year,⁴ the manual nature of the work, and the EO function's limited staffing in this program area.

For Foundation Follow-Up cases closed during FY 2001, EO function employees charged 23,912 hours to review financial information and contact the tax exempt organizations for additional information, if needed. In addition, EO function management estimates that another 4,825 hours were charged in FY 2001 to generate and issue follow-up letters, control cases on the EDS, issue any letters informing the organizations that they are presumed to be

³ See Appendix V for the results of our detailed case analyses.

⁴ We identified 18,665 exempt organizations with an advance ruling end date in FY 2001. Of those, 13,021 (70 percent) had an advance ruling end date in December 2000. EO function management stated that most exempt organizations maintain accounting records on a calendar year basis, so their advance ruling period would end in December.

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private foundations, copy case files to microfiche, and store case documentation. This equates to a total of 13.8 Full-Time Equivalents (FTE)⁵ for this program.

Foundation Follow-Up cases usually result in no change to the foundation status of the exempt organization

The EO function rarely changes the foundation status of an exempt organization based upon the Foundation Follow-Up process. For example, EO function management conducted EDS research and determined that 560 (3.4 percent) of the 16,458 advance rulings in FY 2001 resulted in an adverse determination (i.e., a change in foundation status from public charity to private foundation). Our review of 173 cases closed during FY 2001 identified only 4 adverse determinations (2.3 percent). In FY 2002, information on the EDS indicated that 459 (3.2 percent) of the 14,223 advance rulings resulted in an adverse determination. This trend continued into FY 2003, where our review of 74 cases closed during the first quarter of that year identified only 2 adverse determinations (2.7 percent).

The financial information requested during the Foundation Follow-Up process is already provided by those organizations that annually file Form 990

Most tax exempt organizations are required to file a Form 990 if their gross receipts are greater than \$25,000 per year. Schedule A, Part IV-A, of the Form 990 (shown in Appendix VII) is required for all I.R.C. § 501(c)(3) entities filing a Form 990 and includes financial data for the past 4 years. This is the same financial information organizations are required to provide for their Foundation Follow-Up reviews. The Schedule A of Form 990 also requires the organization to substantiate that it is publicly supported. Each year, when exempt organizations file Form 990, they must complete a public support test using the prior 4 years of financial data on the Schedule A of the Form 990.

⁵ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

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Currently, some Schedule A data are transcribed by IRS personnel into a computer system to update the exempt organization's account on an IRS database. On a weekly basis, any new information is taken from this database and added to the TE/GE Division's Return Inventory and Classification System (RICS) for use by EO Examination function personnel. The information transcribed includes most of the financial data necessary to determine foundation status, but not the results of the public support test.

Our analysis of all the exempt organizations which had an advance ruling period ending in FY 2001 showed that 78 percent (14,502 of 18,565⁶) were required to file a Form 990, including Schedule A. If the three additional lines⁷ showing the results of the public support test from the Schedule A of the Form 990 were transcribed and available on the RICS, EO function personnel could more efficiently perform Foundation Follow-Up work. By researching the RICS for advance ruling cases, EO function personnel may be able to determine if organizations that have filed a Form 990 qualify as a public charity or private foundation without contacting the organization. This alternative process could greatly reduce both the amount of manual processing by EO function personnel and the burden on tax exempt customers.

Using the figure of 13.8 FTEs estimated for time worked on Foundation Follow-Up cases in FY 2001, the EO function could reallocate up to 78 percent of these resources, or 10.73 FTEs, to more productive oversight of exempt organizations, such as determination or examination work.⁸

⁶ We identified 18,665 exempt organizations with an advance ruling end date in FY 2001. We selected a statistical sample from 18,565 cases because 100 cases related to amended requests for tax exempt status (e.g., changes in the address or board members for the organization) and the EO function did not perform any follow-up work related to an advance ruling determination for these cases.

⁷ See Appendix VII, lines 26f, 27f, and 27g.

⁸ EO function management could not estimate how much time would be spent researching the RICS if the results of the public support test from Schedule A of the Form 990 were available on this system. The 10.73 FTEs available for reallocation would need to be reduced by the time needed for RICS research. See Appendix IV for additional detail.

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In addition, the TE/GE Division could eliminate the need for exempt organizations to provide information during the advance ruling process that has already been provided during the annual Form 990 filing. The remaining 22 percent of exempt organizations that do not have filing requirements would still have to submit their financial information for review.

Furthermore, the public support test information on the RICS could be used by EO Examination function personnel to ensure continued compliance by exempt organizations. EO Examination function personnel could research the public support test results for exempt organizations that have been given a definitive ruling and that file Forms 990 to ensure they are still operating with the proper levels of public support.

The IRS is also in the process of developing an electronic filing system for Forms 990 that will capture 100 percent of the information on the Form 990 and any attachments. The system's initial deployment is scheduled for January 2004. If transcription of the additional information from the Schedule A of the Form 990 is not feasible, the TE/GE Division should consider using this information when the Form 990 electronic filing initiative is implemented.

Recommendation

1. The Director, EO, should pursue alternative approaches to more efficiently conduct Foundation Follow-Up reviews, such as transcribing additional data from the Form 990 onto the RICS or using the data from electronically filed Forms 990 once this system is deployed.

Management's Response: The Director, EO Rulings and Agreements, has given the Form 990 redesign group and the Form 990 e-filing initiative office 6 months to develop recommendations to use Form 990 information to classify organizations as publicly supported at the end of their 5 year advance ruling period.

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Foundation Follow-Up Case Information Is Not Always Updated on the Computer System

An IRS computer system does not always contain accurate information related to exempt organizations that have been reclassified as private foundations during the Foundation Follow-Up process. Specifically, we selected 2 limited samples totaling 70 exempt organizations reclassified as private foundations from public charities (20 definitive adverse rulings and 50 presumptive rulings) and determined that 22 organizations did not have their foundation status or tax filing requirements updated on the Exempt Organizations Business Master File (EOBMF).⁹ This update is important because when the type of return filed by an exempt organization does not match its filing requirements on the IRS computer system, the processing of the return will be delayed until the IRS can resolve the reason for the inconsistency. If the cause of this inconsistency is that the filing requirements were not updated, it could result in inefficient use of IRS resources because of unnecessary taxpayer contacts and increased burden on the exempt organization.

An adverse determination results in an exempt organization's foundation status changing from public to private, which affects the filing requirements of the tax exempt entity. Definitive adverse rulings are a result of exempt organizations providing financial information that indicates they are not publicly supported. When a definitive adverse ruling is closed on the EDS using a certain closing code, the exempt organization's new foundation status and filing requirements are systemically updated to the EOBMF after the case passes two separate validity tests. If the case fails the first validity check (due to EDS inconsistencies), it is listed on an error report and resolved by EO Determination function personnel. If the case fails the second validity check (due to EOBMF inconsistencies), it is resolved by Small Business/Self-Employed (SB/SE) Division personnel at the Cincinnati Campus.

Presumptive rulings are similar to adverse determinations in that the exempt organization's foundation status changes from public to private. However, the closing code used to

⁹ The EOBMF is the IRS' computer system for all exempt organizations that have had an application for exemption processed.

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close presumptive rulings on the EDS does not systemically update the exempt organization's foundation status and filing requirements on the EOBF. Instead, EO function personnel must manually update the EOBF with the new information.

Definitive adverse determination information is not always updated to the EOBF

We selected a random sample of 20 definitive adverse determinations closed in FY 2001 to determine if the EOBF was properly updated with the new foundation status and filing requirements of the entities. Four exempt organizations (20 percent) never had their IRS computer records systemically updated to reflect the change from a public charity to a private foundation. One of these four organizations has since been terminated. After we informed EO function personnel of the remaining three cases, they took the necessary action to ensure accurate information was input to the EOBF.

EO function management did not know why the four exception cases were never updated to the EOBF. One of the cases failed the initial EDS validity checks and should have appeared on the EDS error report for resolution by EO function personnel. Another case passed the initial EDS validity check and was forwarded to the EOBF for the second validity check. We contacted SB/SE Division personnel at the Cincinnati Campus and determined that reports showing EO function cases that failed the second validity check are received by SB/SE Division personnel for resolution. We are not making a recommendation related to SB/SE Division actions on this case because another Treasury Inspector General for Tax Administration audit¹⁰ has evaluated the effectiveness of the TE/GE Division's oversight to ensure SB/SE Division personnel are effectively resolving filing errors associated with TE/GE Division returns. In the remaining two cases, there was

¹⁰ *Additional Emphasis Is Needed to Reduce the Burden for Tax Exempt and Government Entities Division Customers During Returns Processing* (Audit Number 200310018, Draft Report dated August 2003).

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insufficient information to determine which validity check stopped information from being updated to the EOBFM.

Presumptive ruling determination information is not always updated to the EOBFM

We selected a random sample of 50 presumptive ruling cases closed in FY 2001 to determine if the EOBFM was updated to reflect both the change in the organization's status to a private foundation and the revised filing requirements. In three cases, we did not have adequate documentation to determine if the information was updated as required. In the remaining 47 cases, we determined that 18 did not have their foundation status or filing requirements manually updated at the time of case closing to reflect their change to a private foundation. In 6 of the 18 cases, the information was never updated on the EOBFM as required; however, EO function management indicated that the exempt organizations subsequently provided information to support their public charity status. As a result, information on the EOBFM is now accurate and does not need to be changed. After we brought the remaining 12 cases to EO function management's attention, they ensured that the correct foundation code and filing requirements were input to the EOBFM.

Recommendations

To address the conditions identified above, we recommend that the Director, EO:

2. Reemphasize that the EDS error report needs to be effectively resolved to ensure accurate foundation status and filing requirements are updated on the IRS computer system.

Management's Response: The Director, EO Rulings and Agreements, will request recommendations from the Manager, EO Determinations, regarding ways to ensure accurate EDS information is provided to the EOBFM.

3. Create a separate closing code on the EDS (and the new Tax Exempt Determination System [TEDS] under development) that systemically updates the EOBFM for

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presumptive ruling cases, similar to the closing code for definitive adverse rulings.

Management's Response: The TEDS team will address this issue for the EO function during the TEDS redesign phase, expected to be implemented by December 31, 2005.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to evaluate the Exempt Organizations (EO) function's process of following up on advance rulings and appropriately classifying the exempt organizations. The following tests were performed to accomplish this objective:

- I. Determined if the EO Determination function timely verified eligibility for public foundation status for advance rulings.
 - A. Selected a statistical sample¹ of 298 cases from the Employee Plans/Exempt Organizations Determination System (EDS) extract that consisted of 18,565² EO Determination function cases with advance ruling end dates during Fiscal Year (FY) 2001 to determine if the EO Determination function initiated timely follow-up actions prior to the end of the advance ruling period.
 - B. Selected a statistical sample³ of 191 Foundation Follow-Up cases from 15,665 cases closed during FY 2001, as well as a judgmental⁴ sample of 75 Foundation Follow-Up cases closed during the first quarter of FY 2003, to determine if the EO Determination function timely processed Foundation Follow-Up cases.
- II. Analyzed the cases selected in Objective I.B. and determined if the EO Determination function properly classified Foundation Follow-Up cases (private versus public) based on the financial information provided for the advance ruling period.
- III. Determined if the EO Determination function updated the filing requirements on the Exempt Organizations Business Master File⁵ for organizations reclassified as private foundations (definitive and presumptive rulings) on the EDS based on the financial information provided for the advance ruling period.

¹ We used an attribute sampling formula with a 90 percent confidence level, a precision rate of 5 percent, and an expected error rate not to exceed 50 percent.

² We identified 18,665 exempt organizations with an advance ruling end date in FY 2001. We selected a statistical sample from 18,565 cases because 100 cases related to amended requests for tax exempt status (e.g., changes in the address or board members for the organization), and the EO function did not perform any follow-up work related to an advance ruling determination for these cases.

³ We used an attribute sampling formula with a 90 percent confidence level, a precision rate of 5 percent, and an expected error rate not to exceed 20 percent.

⁴ We used a judgmental sampling methodology because we did not plan to project our results.

⁵ The Exempt Organizations Business Master File is the Internal Revenue Service's computer system for all exempt organizations that have had an application for exemption processed.

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- A. Selected 2 judgmental samples⁶ totaling 70 Foundation Follow-Up cases closed during FY 2001 that consisted of 20 organizations (from a population of 558) reclassified as private foundations based on sufficient financial information provided for the advance ruling period and 50 organizations (from a population of 370) reclassified as private foundations based on insufficient financial information provided for the advance ruling period.

⁶ We used a judgmental sampling methodology because we did not plan to project our results.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:SE
Director, Exempt Organizations, Tax Exempt and Government Entities Division T:EO
Director, Communications and Liaison, Tax Exempt and Government Entities Division T:CL
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; 10.73 Full-Time Equivalents (FTE)¹ (see page 3).

Methodology Used to Measure the Reported Benefit:

The current method for conducting Foundation Follow-Up reviews is a labor-intensive, manual process resulting in few changes to the foundation status of the exempt organizations. In Fiscal Year (FY) 2001, 23,912 hours were charged to Foundation Follow-Up cases closed on the Employee Plans/Exempt Organizations Determination System (EDS). In addition to this time, an estimated 4,825 hours were spent by administrative staff to issue letters, control case files, copy case files to microfiche, and retain case files of Foundation Follow-Up cases.

By using the same type of financial information reported on the Return of Organization Exempt From Income Tax (Form 990) for the Foundation Follow-Up review, the Exempt Organizations (EO) function may be able to reallocate resources to more productive oversight of exempt organizations, such as determination or examination work.² We identified that 78 percent of exempt organizations with advance ruling end dates in FY 2001 had a Form 990 filing requirement. By multiplying the total number of hours (28,737) by 78 percent, we arrived at a total of 22,415 hours that could be reallocated to other EO function processes.

We then divided the 22,415 hours by the total number of hours per FTE to determine the total number of FTEs that could be reallocated.

28,737 hours multiplied by 78 percent = 22,415 hours

22,415 hours divided by 2,088 hours = 10.73 FTEs

¹ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

² EO function management could not estimate how much time would be spent researching the Return Inventory and Classification System (RICS) if the results of the public support test from Schedule A of the Form 990 were available on this system. The 10.73 FTEs available for reallocation would need to be reduced by the time needed for the RICS research.

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Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 14,502 taxpayers (see page 3).

Methodology Used to Measure the Reported Benefit:

An EDS extract included 18,565³ exempt organizations with advance ruling end dates in FY 2001. Of these taxpayers, 14,502 also had a Form 990 filing requirement on the EDS. These organizations provide the same financial information during their Foundation Follow-Up reviews that they have already reported on their Forms 990. By using the information reported by the organizations on their Forms 990, EO function personnel may be able to eliminate the need for organizations to send in their financial information for the advance ruling period as well as any corresponding customer contact.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 22 taxpayers (see page 8).

Methodology Used to Measure the Reported Benefit:

We reviewed 2 random samples totaling 70 exempt organizations reclassified as private foundations from public charities (20 definitive adverse rulings and 50 presumptive rulings). Our review showed that 22 of the 70 exempt organizations did not have their foundation status or tax filing requirements updated on the Exempt Organizations Business Master File (EOBMF).⁴ This update is important because when the type of return filed by an exempt organization does not match its filing requirements on the Internal Revenue Service's (IRS) computer system, the processing of the return will be delayed until the IRS can resolve the reason for the inconsistency.

³ We identified 18,665 exempt organizations with an advance ruling end date in FY 2001. We selected a statistical sample from 18,565 cases because 100 cases related to amended requests for tax exempt status (e.g., changes in the address or board members for the organization) and the EO function did not perform any follow-up work related to an advance ruling determination for these cases.

⁴ The EOBMF is the IRS' computer system for all exempt organizations that have had an application for exemption processed.

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Appendix V

Results of Detailed Case Analyses

The following three tables summarize the detailed case analyses performed to determine if the Exempt Organizations (EO) function: (1) followed up on all advance rulings and whether the follow-up was timely and (2) timely classified Foundation Follow-Up cases and whether they were properly classified as public charities or private foundations.

Table 1: Sample of Cases With Advance Ruling End Dates in Fiscal Year 2001

Total Cases Sampled	Total Cases Reviewed*	Cases Followed Up on as Required	Cases Followed Up on Timely	Cases Followed Up on Untimely	Inadequate Documentation for Timeliness Determination**
298	296	296	16	185	95

* Two cases did not meet our selection criteria.

** Documentation was not available to make a definitive determination on the timeliness of the follow-up actions taken.

We selected a sample of cases from each of two Employee Plans/Exempt Organizations Determination System extracts to determine the timeliness of Foundation Follow-Up case processing. Our results are summarized in Table 2. We then requested the case files for the same two samples to determine if the exempt organizations were properly classified as public charities or private foundations. These results are summarized in Table 3.

Table 2: Sample of Closed Foundation Follow-Up Cases - Timeliness

	Total Cases Reviewed	Timely Processed	Untimely Processed
Fiscal Year 2001	191	119	72
First Quarter Fiscal Year 2003	75	31	44

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Table 3: Sample of Closed Foundation Follow-Up Cases – Proper Classification

	Total Cases Sampled	Total Cases Reviewed*	Properly Classified	Not Properly Classified	Inadequate Documentation
Fiscal Year 2001	191	173	173	0	0
First Quarter Fiscal Year 2003	75	74	72	1**	1***

* The EO function could not locate 19 cases (18 from the Fiscal Year 2001 sample and 1 from the Fiscal Year 2003 sample).

** The caseworker did not receive all the necessary information from the exempt organization to make a definitive ruling. Based on established procedures, the exempt organization should have been presumed to be a private foundation instead of maintaining its public charity status. EO function management indicated that the caseworker made a judgment call that it was in the best interest of the Internal Revenue Service to approve the organization's public charity status after reviewing the incomplete financial information, which reported typical sources of income for that type of organization.

*** The financial information obtained from the organization was not in the case file, so we could not determine if the EO function properly classified the exempt organization.

The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

Appendix VI

Form 8734

Form 8734 (Revised January 2002)	Department of the Treasury - Internal Revenue Service					
Name of Organization	Support Schedule For Advance Ruling Period					
	Employer Identification Number					

For information on completing this support schedule, refer to the instructions for Form 990 (Schedule A, Part IV), or call TE/GE Customer Account Services at 877-829-5500 between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday.

NOTE: If you did not receive any support for a given year, please be sure to show financial data for that year by indicating -0- or -none-. Year 1 should reflect support received as of the date legally organized, unless otherwise specified in the determination letter.

	Year 1	Year 2	Year 3	Year 4	Year 5	TOTAL
1. Gifts, grants, and contributions received. (Do not include unusual grants. See line 14)						
2. Membership fees received						
3. Gross receipts from admissions, merchandise sold or services performed, or furnishing of facilities in any activity that is not a business unrelated to the organization's charitable, etc., purpose						
4. Gross income from interest, dividends, amounts received from payments on securities loans (section 312(a)(5)), rents, royalties, and unrelated business taxable income (less section 511 taxes)						
5. Net income from unrelated business activities not included in line 4.						
6. Tax revenues levied for your benefit and either paid to you or expended on your behalf						
7. The value of services or facilities furnished to you by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge						
8. Other income. Attach schedule. Do not include gain (or loss) from sale of capital assets						
9. Total of lines 1 through 8						**
10. Line 9 minus line 3						
11. Enter 1% of line 9						
12. Organizations described in section 170(b)(1)(A)(vi):						
a. Enter 2% of amount shown in TOTAL column, line 10 **						Yes _____ No _____
b. For all years, did total contributions from any person other than a governmental unit or publicly supported organization exceed the amount shown on line 12a? If yes, attach a list showing the name of and amount contributed by each person whose total gifts exceeded the 2% amount. If available, please list the contributing organization's Employer Identification Number (EIN).						Yes _____ No _____

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The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

(Page 2 of 2)

13. Organizations described in section 509(e)(2):

a. Attach a list, from amounts shown on lines 1, 2, and 3 showing the name of, and total amounts received in each year from each "disqualified person," and enter the sum of such amounts for each year:

Year 1 _____ Year 2 _____ Year 3 _____ Year 4 _____ Year 5 _____
b. Attach a list showing, for each year, the name and amount included in line 3 for each person (other than "disqualified persons") from whom the organization received more, during that year, than the larger of the amount on line 11 for the year or \$5,000. Include organizations as well as individuals. Enter the sum of these excess amounts for each year:
Year 1 _____ Year 2 _____ Year 3 _____ Year 4 _____ Year 5 _____

14. If you received any unusual grants during your advance-ruling period, attach a list for each year showing the contributor, the date and amount of the grant, and a brief description of the nature of the grant. Do not include these in line 1, page 1.

15. Please list the name and telephone number of an officer, director, or trustee who can be contacted during business hours if we need more information. If someone other than an officer, director or trustee will represent the organization or sign this document, attach Form 2846, Power of Attorney.

Name: _____ Phone: (____) _____ Fax Number (if available): (____) _____

16. In order that the organization's current address is properly recorded, please provide the following:

Mailing Address:

Location Address (if different from mailing address):

Under penalties of perjury, I declare that I am authorized to sign this schedule on behalf of this organization and that I have examined this schedule, including accompanying statements, and to the best of my knowledge and belief it is true, correct, and complete.

Type or Print Name

Signature

(Title or authority of signer)

(Date)

(Telephone No.)

This completed support schedule should be returned to:

Internal Revenue Service
P.O. Box 192
Covington, Kentucky 41012

Form 8734 (Rev. 1-2002)

The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

Appendix VII

Schedule A, Part IV-A, of Form 990

Schedule A (Form 990 or 990-EZ) 2002

Page **3**

Part IV-A Support Schedule (Complete only if you checked a box on line 10, 11, or 12.) *Use cash method of accounting.*
Note: You may use the worksheet in the instructions for converting from the accrual to the cash method of accounting.

Calendar year (or fiscal year beginning in)	(a) 2001	(b) 2000	(c) 1999	(d) 1998	(e) Total
15 Gifts, grants, and contributions received. (Do not include unusual grants. See line 28.)					
16 Membership fees received					
17 Gross receipts from admissions, merchandise sold or services performed, or furnishing of facilities in any activity that is related to the organization's charitable, etc., purpose					
18 Gross income from interest, dividends, amounts received from payments on securities loans (section 512(a)(5)), rents, royalties, and unrelated business taxable income (less section 511 taxes) from businesses acquired by the organization after June 30, 1975					
19 Net income from unrelated business activities not included in line 18					
20 Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf					
21 The value of services or facilities furnished to the organization by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge.					
22 Other income. Attach a schedule. Do not include gain or (loss) from sale of capital assets					
23 Total of lines 15 through 22					
24 Line 23 minus line 17					
25 Enter 1% of line 23					
26 Organizations described on lines 10 or 11:					
a Enter 2% of amount in column (e), line 24					26a
b Prepare a list for your records to show the name of and amount contributed by each person (other than a governmental unit or publicly supported organization) whose total gifts for 1998 through 2001 exceeded the amount shown in line 26a. Do not file this list with your return. Enter the total of all these excess amounts					26b
c Total support for section 509(a)(1) test: Enter line 24, column (e)					26c
d Add: Amounts from column (e) for lines:					
18 _____ 19 _____					26d
22 _____ 26b _____					26e
e Public support (line 26c minus line 26d total)					26f
f Public support percentage (line 26e (numerator) divided by line 26c (denominator))					%
27 Organizations described on line 12:					
a For amounts included in lines 15, 16, and 17 that were received from a "disqualified person," prepare a list for your records to show the name of, and total amounts received in each year from, each "disqualified person." Do not file this list with your return. Enter the sum of such amounts for each year:					
(2001) _____ (2000) _____ (1999) _____ (1998) _____					
b For any amount included in line 17 that was received from each person (other than "disqualified persons"), prepare a list for your records to show the name of, and amount received for each year, that was more than the larger of (1) the amount on line 25 for the year or (2) \$5,000. (Include in the list organizations described in lines 5 through 11, as well as individuals.) Do not file this list with your return. After computing the difference between the amount received and the larger amount described in (1) or (2), enter the sum of these differences (the excess amounts) for each year:					
(2001) _____ (2000) _____ (1999) _____ (1998) _____					
c Add: Amounts from column (e) for lines:					
15 _____ 16 _____					27c
17 _____ 20 _____ 21 _____					27d
d Add: Line 27a total _____ and line 27b total _____					27e
e Public support (line 27c total minus line 27d total)					27f
f Total support for section 509(a)(2) test: Enter amount from line 23, column (e)					27g
g Public support percentage (line 27e (numerator) divided by line 27f (denominator))					%
h Investment income percentage (line 18, column (e) (numerator) divided by line 27f (denominator))					%
28 Unusual Grants: For an organization described in line 10, 11, or 12 that received any unusual grants during 1998 through 2001, prepare a list for your records to show, for each year, the name of the contributor, the date and amount of the grant, and a brief description of the nature of the grant. Do not file this list with your return. Do not include these grants in line 15.					

Schedule A (Form 990 or 990-EZ) 2002

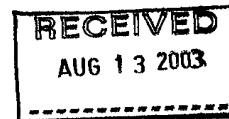
The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

Appendix VIII

Management's Response to the Draft Report




DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



AUG 13 2003

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Evelyn A. Petschek 
Commissioner, Tax Exempt and Government Entities

SUBJECT: Response to Draft Audit Report: The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process (Audit 200210051)

I reviewed your draft report on the Exempt Organizations (EO) process of following up on advance rulings for foundations and appropriately classifying these exempt organizations. The process involved in determining a final foundation status for organizations at the end of their five-year advance ruling period is labor intensive.

I am pleased the report found that we conducted the foundation follow-up program in an accurate manner. I also appreciate the report's suggestion that we consider using the Form 990 as the primary vehicle to more efficiently manage this program.

Our comments on the recommendations are as follows:

IDENTITY OF RECOMMENDATION 1

Pursue alternative approaches to more efficiently conduct Foundation Follow-Up reviews, such as transcribing additional data from the Form 990 onto the RICS or using the data from electronically filed Forms 990 once this system is deployed.

CORRECTIVE ACTIONS

We have given the Form 990 redesign group and the Form 990 e-filing initiative office six months to coordinate and present recommendations regarding using Form 990 information to classify organizations as publicly supported at the end of their five-year advance ruling period.

IMPLEMENTATION DATE

March 15, 2004

RESPONSIBLE OFFICIAL

Director, EO Rulings and Agreements

The Tax Exempt and Government Entities Division Could Improve the Efficiency of Its Advance Ruling Follow-Up Process

2

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action through the Joint Audit Management Enterprise System (JAMES).

IDENTITY OF RECOMMENDATION 2

Re-emphasize that the EDS error report needs to be effectively resolved to ensure that accurate foundation status and filing requirements are updated on the IRS computer system.

CORRECTIVE ACTION

The Director, EO Rulings and Agreements will request recommendations from the Manager, EO Determinations regarding ways to ensure the accuracy of the EDS information that is provided to Exempt Organizations Business Master File.

IMPLEMENTATION DATE

January 15, 2004

RESPONSIBLE OFFICIAL

Director, EO Rulings and Agreements

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action through the JAMES system.

IDENTITY OF RECOMMENDATION 3

Create a separate closing code on the EDS (and the new Tax Exempt Determination System under development) that systemically updates the EOBFM for presumptive ruling cases, similar to the closing code for definitive adverse rulings.

CORRECTIVE ACTION

We expect to implement the redesign of EDS (TEDS) for EO by December 31, 2005. We will ask the TEDS team to address this issue during the redesign phase.

IMPLEMENTATION DATE

December 31, 2005

RESPONSIBLE OFFICIALS

Director, EO Rulings and Agreements
Manager, EO Determinations

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action through the JAMES system.